Docket No. 13608

United States Court of Appeals

For the Ninth Circuit

THE JOHN DANZ CHARITABLE TRUST, *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

ON PETITION FOR REVIEW OF DECISION OF THE TAX COURT OF THE UNITED STATES

PETITION FOR REHEARING

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To the Honorable Walter L. Pope and James Alger Fee, Circuit Judges, and the Honorable Chase A. Clark, District Judge:

Comes now Petitioner, by and through its attorneys, and petitions this Court for a rehearing in the above entitled case for the following reasons:

The majority opinion in this case denies deduction under Internal Revenue Code (1939) Section 162(a), as to income earned but not actually paid to charitable beneficiaries during the year, on the grounds:

(1) That there must be a named beneficiary pointed out with precision before it can be said that income has been "permanently set aside" under the first clause of Section 162(a), and

(2) That to obtain deduction under the second clause of Section 162(a) for income "to be used exclusively"

for charitable purposes, payment must be made within the taxable year, and

(3) That where the trust instrument permits use of the income in business or speculation, particularly where the investment may be made in conjunction with investment of private funds, the fact that all corpus and income of the trust must at some future date be paid to charitable organizations is not sufficient to bring it within the second clause of Section 162(a) pertaining to income which is to be used exclusively for charitable purposes.

This is the first time, as far as we can find, that any court has held that there must be a named beneficiary before deduction may be allowed under Section 162(a) for income which is to be accumulated. None of the statutes, regulations or rulings relating to this matter have ever so indicated. Moreover, the decisions in *Comm. v. Upjohn's Estate,* 124 F.(2d) 73 (C.C.A. 6); *Schoellkopf v. U. S.,* 124 F.(2d) 982 (C.C.A. 2); *Beggs v. U. S.,* 27 F.Supp. 599 (Ct. Cls.), and *Arthur Jordan Foundation v. Comm.,* 210 F.(2d) 885 (C.A. 7) are directly in conflict.

While this case involves the Internal Revenue Code provisions existing in the years 1943-1947, it is clear that the principles of law announced in the opinion are just as applicable today. The principles announced are based on a construction of the language of the two clauses of Section 162(a). These remained unchanged until the Internal Revenue Code of 1954 and they have been carried into the 1954 Code as Section 642(c) with no change of substance. If the language used in Section 162(a) of the 1939 Code meant what the majority opin-

ion here announces, then the language now in effect as Section 642(c) of the 1954 Code means the same thing.

Under the principles announced in this case a charitable trust whose precise beneficiaries are to be designated in the future may not secure deduction under Section 162(a) of the 1939 Code or Section 642(c) of the 1954 Code except for amounts actually paid out during the year. The majority opinion appears to so hold irrespective of whether the investment powers extend to business and speculative investments. Where the trustees have power to engage in business or other speculative investments it is clear that this result follows from the majority opinion. Nor does the opinion make this result dependent on any exercise of speculative investment powers by the trustees. The denial of deduction is said to follow as a matter of law from the fact that precise beneficiaries have not been designated, and, assuming that the opinion intends any further qualification, from the mere existence of speculative investment powers.

This construction of the statute limits deduction, on the basis of the language of these two clauses themselves, far beyond the limitations accomplished by the additional subsection 162(g), added by Section 321 of the Revenue Act of 1950 (64 Stat. 906, 954) and carried forward as Section 681 of the Internal Revenue Code of 1954 (68 A Stat. 232). Yet this new subsection (g) was the result of extensive hearings as to what the law should be in this respect and was adopted by Congress to limit after 1950 the deduction previously granted in situations where business income was received, where private benefit might be received, where

retention of income beyond the year earned was unreasonable, or where investments jeopardized the charitable purposes.

Subsection (1) of this subsection (g) denies deduction after 1950 of certain income actually received from business enterprises. Even in situations where it is applicable it permits deduction of the other income of the trust. The majority opinion here, however, totally denies deduction of *any* income, whether from government bonds or any other investments, and irrespective of whether the trust actually has received business income, if the trust instrument gives the trustees power to make business or speculative investments. If the majority opinion is correct, then this provision of subsection (g) adopted by Congress was useless.

Subsection (4) of this subsection (g) provides that after 1950 if income permanently set aside or to be used exclusively for charitable purposes is unreasonable in amount or duration in order to carry out the purposes of the trust, the deduction shall be limited to the amounts actually paid out. There is no suggestion in subsection (g) that this statute deals only with situations where a named beneficiary has been designated for all of the income and, as is well known, a large proportion of charitable trusts have provision for future designation of beneficiaries. The wording of subsection (g) (4) indicates that Congress understood that a trust could get deduction, under both clauses of Section 162(a), for income not paid out during the year, and that Congress intended to deny such deduction after 1950 only where the accumulation was unreasonable. Yet the majority opinion here holds that where

named beneficiaries have not been designated no deduction is permissible for *any* accumulated income.

Moreover, the wording of subsection (g)(4) indicates Congress' understanding that the language of Section 162(a) permitted deduction of accumulated income under the "is to be used exclusively" provisions of the second clause. The majority opinion here holds that the "is to be used exclusively" language relates only to amounts paid out within the taxable year and does not apply to accumulations.

Subsection (g)(4) also limits deduction after 1950 to amounts actually paid out if the funds are invested in such a manner as to jeopardize the interests of the charitable beneficiaries. It is the *actual* investment in such manner, not the *mere possibility* of such an investment, that will defeat deduction. The investments of Petitioner here did not jeopardize the interests of the beneficiaries. All investments were in accepted and traditional charitable trust assets of improved real estate and blue chip stocks except for $3,889.75 put into the candy shops, an amount only six-tenths of one per cent of the total investments made during the years involved. All investments were, moreover, highly successful. Yet the majority opinion here denies deduction because under their power to make speculative investments the trustees *might* in the *future* so invest the money as to have losses. Again this goes far beyond the limitations which Congress saw fit to adopt when considering this exact question.

The majority opinion cites as one reason for denying deduction the power of the trustees to make investments jointly with other trusts, stating: "But, appar-

ently, the profits of operations were to be turned over to The John Danz Charitable Trust, 'Trust A,' and to the six private trusts pro rata according as the funds of each were used in the particular business or speculation." This seems to assume that joint investments were made and further seems to assume that the joint investments were made and controlled by some other entity. The fact is, as the Tax Court found (R. 117), that no joint investments were made. Title to all of the assets of the Charitable Trust was taken in the name of the trustees of this trust and the receipts, income, funds, property and disbursements of the Charitable Trust have been separately and fully accounted for (R. 91, 112).

In light of these facts, the majority opinion must be taken as laying down the rule that the mere existence of a power to make joint investments, particularly of a speculative character, is reason for denying to a charitable trust the right to deduct income derived, not from any joint investments but from its wholly-owned and, except for a *de minimis* amount, non-speculative investments. The only reason that we could conceive for such a rule would be fear that through future joint investments some diversion or private benefit might result. Yet Congress, when considering what would be desirable limitations on deductions under Section 162 (a), adopted no such provision, and, even where substantial private benefit had actually occurred by reason of transactions with the donor, simply limited the deduction to 15% of net income (Subsection (2)(B) of Section 162(g) *supra*). No diversion has occurred here whether through joint investments or through any

other means, and, in fact, no diversion could occur from joint investments even if they were made, because under ordinary legal principles governing trusts the trustees would be required to keep careful record and accounting and would not be permitted by any court to confuse or commingle the funds. The opinion in this case in this respect, also, limits deduction on the basis of construction of the language of Section 162(a) itself far beyond the limitations imposed by Congress by separate enactment after prolonged consideration.

The instant decision will create substantial confusion in the drafting of charitable trust instruments. In the face of this decision, no careful lawyer could advise his client that if a charitable trust were drawn to permit accumulation of income and future designation of beneficiaries, tax deduction would be permitted. Nor could he advise in favor of including in a charitable trust agreement powers to invest in business or other speculative investments, even where the 1950 act would pose no problem. Nor could he include the provision (usual in modern trust instruments, particularly where a corporate trustee is named) permitting investment in common trust funds, for fear of losing tax deduction. He would have to advise his client that the carefull considered legislation enacted by Congress in 1950 no longer stated the applicable limitations on tax deduction by charitable trusts.

Most substantial charitable trusts are drawn to last for long periods of time during which conditions may change so drastically as to make inadvisable the precise naming of beneficiaries at the outset and to make dangerous a too narrow limit on investment powers. In

periods of inflation the capital value of the fund is more likely to be lost through too conservative an investment policy than through well considered business investments even though speculative in character. The danger of narrow powers is demonstrated in this case by the necessity imposed on the trustees to operate the Savoy Hotel for a period of time because of inability to find a suitable tenant. Any draftsman of a charitable trust agreement hereafter will be faced with a most difficult dilemma, in the face of the instant decision, in deciding what is and what is not a speculative investment power under this decision and in determining how he can give the trust adequate power to meet future emergencies or inflation and still comply with this decision.

The future establishment of the ordinary charitable trust or foundation as we have known it in this country, *i.e.,* a trust where the trustees or others are to designate beneficiaries in the future and income not used for current charitable payments is to be accumulated will be rendered hazardous from a tax standpoint if the opinion of this Court stands that a trust cannot deduct accumulated income unless beneficiaries for all principal and income have been designated with precision. The taxability of the income of the thousands of trusts of this type already created will be thrown into confusion. We urge that before finally enunciating, in conflict with several previous Circuit Court decisions, principles which will produce such results and which will nullify many provisions for charitable trusts adopted by Congress in 1950 after prolonged hearings

and debate, this Court should give most serious and careful consideration to the problem.

We respectfully ask that a rehearing be ordered in this case.

Respectfully submitted,

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15th Floor, Hoge Building,
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Date: November 16, 1955.

CERTIFICATE OF COUNSEL

The undersigned, F. A. LeSourd, attorney for Petitioner in this cause, does hereby certify that he prepared the foregoing petition for rehearing; that in his judgment it is well founded and that it is not interposed for delay.

F. A. LeSourd

Subscribed and sworn to before me this 17th day of November, 1955.

M. E. Davies
Notary Public in and for
the State of Washington
residing in Seattle.